MARKET PERSPECTIVE

OCTOBER, 2014

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> *"Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, and one by one."*
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> *Charles Mackay 1812-1889*

IN VIEW:

More than 125 years ago, Charles Mackay observed the maniac behavior of crowd psychology - which still persists today. The well-published October market declines gave the hungry bears the signal they have been waiting for and encouraged sensible investors to react emotionally. Long-term investments were liquidated with the expectation of an imminent bear market that would ultimately be reinforced by the long-awaited global recession and the inherent consequences. As the month unfolded, fear gripped markets as pundits predicted doom and gloom in reaction to rapidly declining equity prices. One has to ponder whether all these bears that surfaced were simply complacent investors only a month ago. We have learned over the decades not to give too much credence to coincident behavioral forces that can strangulate fundamental approaches to investments. We will herein reexamine the efficacy of recent developments that have negatively impacted markets and determine whether this new information warrants a more cautious approach. So let's examine the facts.

The Global Backdrop

The global economic slowdown set the overall tone for what we believe to be an overdue but typical mid-cycle market correction in the financial markets. Although the United States is now one of the few recovering economies, it still remains the world's largest economy. However, investors are far more skittish since growth rates in the U.S. have been decreasing over the past decades – as with many other developed nations. Put into context, this shows that if in the 50's and 60's the average growth rate was above 4 percent, in the 70's and 80's it dropped to around 3 percent. In the last ten years, the average rate has been below 2 percent, and since the second quarter of 2000, we have yet to reach a typical recovery level of 5%.

- ### *Oil Prices Revisited*

The selloff in the large capitalized stock indices in recent weeks coincided with mounting evidence of a global economic slowdown, which we have been monitoring since the start of the year. This development seems to have become of greater concern in recent weeks, as the CRB raw industrials spot price index and the price of a barrel of Brent crude oil have dropped sharply. Some of the drop in commodity prices was undoubtedly accentuated by a strong dollar. In addition, the drop in crude oil prices reflects not only weakening oil demand but too much supply. Figures released on Friday showed OPEC had lifted output by 400,000 barrels a day in September - the biggest monthly increase in almost three years - exaggerating the global slowdown.

The plunge in the price of crude oil should be a positive for the S&P 500 Transportation index. However, in addition to using diesel fuel to power their locomotives, the railroad industry has enjoyed a booming business in transporting crude oil produced by shale drillers. Drillers might have to stop their operations if they turn unprofitable at lower oil prices.

Declining gasoline prices is a big positive for consumers. The nearby futures price of gasoline is down 30% since this year's peak during the summer. Retail sales of gasoline totaled $535 billion during September at a seasonally adjusted annual rate. So a 30% drop in the price would provide a $161 billion windfall to consumers. The weakness in the Energy sector is attributable to the plunge in the price of a barrel of Brent crude oil. It has plunged 27% from this year's high of $115 in June to $82.75 at the close on Friday, October 17th. The ratio of the S&P 500 Energy Index to the S&P 500 is highly correlated with the price of oil. The drop in oil prices is also putting downward pressure on the S&P 500 Industrials sector, because the oil industry spends a lot of money on capital equipment. A rebound in oil prices would create a good buying opportunity for both sectors.

However, the news remains bearish for oil as the International Energy Agency cut its 2015 estimate for global oil demand growth by 300,000 b/d (barrels/day) from its previous forecast and now expects demand growth of 1.1m b/d to 93.5 million. However, investors have to be encouraged that, in theory, lower oil prices should boost demand. The supply side of this equation may continue to weigh on oil prices in the near term. The glut of U.S. shale oil is forcing many OPEC producers to keep producing so as to hold onto their market share. Even Saudi Arabia may no longer be willing to play the role of the swing producer to boost prices.

It appears that the Saudis are hoping that lower oil prices will reduce output in countries with higher production costs. This past Sunday, Kuwait's oil minister said there was a natural floor limiting how low prices could fall, at about $76-$77 per barrel. That, he said, is near the average production costs per barrel in Russia and the U.S. On a positive note, declining petrodollars diminishes the power base for ISIS and Russia which should create a constructive influence in dampening geopolitical instability.

- *The Eurozone and Japanese Conundrum*

Earlier this month, ECB President Mario Draghi indicated that monetary policy may not be the solution to what's ailing the Eurozone economy. Indeed, he ended his prepared remarks by reminding everyone that the main job of the ECB is to maintain price stability. He then continued, "However, in order to strengthen investment activity, job creation and potential growth, other policy areas need to contribute decisively. In particular, the legislation and implementation of structural reforms clearly need to gain momentum in several countries. This applies to product and labor markets as well as to actions to improve the business environment for firms."

He also stressed that "insufficient progress in structural reforms in euro area countries constitutes a key downward risk to the economic outlook." In other words, if the next round of monetary easing programs, including TLTRO liquidity injections and ABS purchases, don't work, don't blame him. These comments certainly reinforced downward pressure on the euro and upward bias on U.S. bond prices.

During the most recent policy committee meeting of the Bank of Japan (BOJ), Governor Haruhiko Kuroda acknowledged that Japan's economy remains stubbornly weak, despite the sharp increase in the monetary base since the implementation of Abenomics* by the bank during April 2013. Extraordinarily, the meeting was halted for over an hour when Kuroda was summoned suddenly before parliament for the second time in less than a week. He was cross-examined about whether the falling yen was hurting rather than helping the economy. He implicitly backed the weakening yen, saying, "when exchange rates move in reflection of financial and economic fundamentals, this is not a minus for the overall economy."

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* Abenomics refers to the economic policies advocated by Shinzo Abe, Prime Minister of Japan. It is based on the "three arrows" of fiscal stimulus, monetary easing and structural reforms."

CLOSE-UP: The Economic Landscape

On September 26, the final revision of second quarter real GDP was announced by the Bureau of Economic Analysis and showed a modest revision upwards to 4.6% from the current growth rate of 4.2%. Much of the improvement stems from the recovery from the weather-induced negative report of minus 2.1% in the first quarter. Assuming growth of approximately 3.0% in the second half of the year, the final tally for the year is expected to be a growth rate of about 2.0%, according to a consensus of economists polled by Bloomberg. Since the economic recovery from the Great Recession which began after June, 2009, economic growth has averaged approximately 2.1%.

The "new normal" growth rate of 2.0%, which compares to the historic 3.25% growth rate of the post-war period, has stirred a major debate among economists as to the reason why growth has significantly slowed in the aftermath of the Great Recession. Many economists believe that the root cause is changing demographics leading to a larger aging population supported by fewer working adults, similar to the pattern which emerged earlier in Japan. Others believe that structural changes have occurred to the work force involving global competition, changing technologies, less investment, and a decline in the work ethic, etc. Not anticipating the exceptionally cold weather in the first quarter, we believed that 2014 would mark the beginning of higher levels of growth of 3.0 or more that would last until the start of 2017, by which time higher levels of inflation and interest rates would lead to a cyclical slowdown.

Since the first quarter, the U.S. economy has performed broadly well at a time when the global economy is again slowing. Europe, which is expected to grow 0.9% in 2014, is facing the possibility of a triple recession aggravated by the possibility of further sanctions on Russia caused by the war in Ukraine. China, the second engine of global growth, is expected to grow 7.0% in 2014 but is facing a major slowdown in real estate and is reluctant to spur growth further because of already excessive credit expansion. The renewed weakness in global growth is reflected in weak commodity prices as we highlighted earlier, such as copper, oil, and gold, despite widespread monetary expansion.

In addition, the global rally in bond prices against the backdrop of still record low interest rates in much of the world suggests concerns of lingering recessionary worries. Such disparate countries as Brazil, Italy, and Russia are back in recession, with Japan somewhat problematic. The investment community didn't expect weak commodity prices and strong bond prices in 2014, because economic forecasts were stronger than the current data. Only in the U.S. - and subsequent to the first quarter - has economic data been strong.

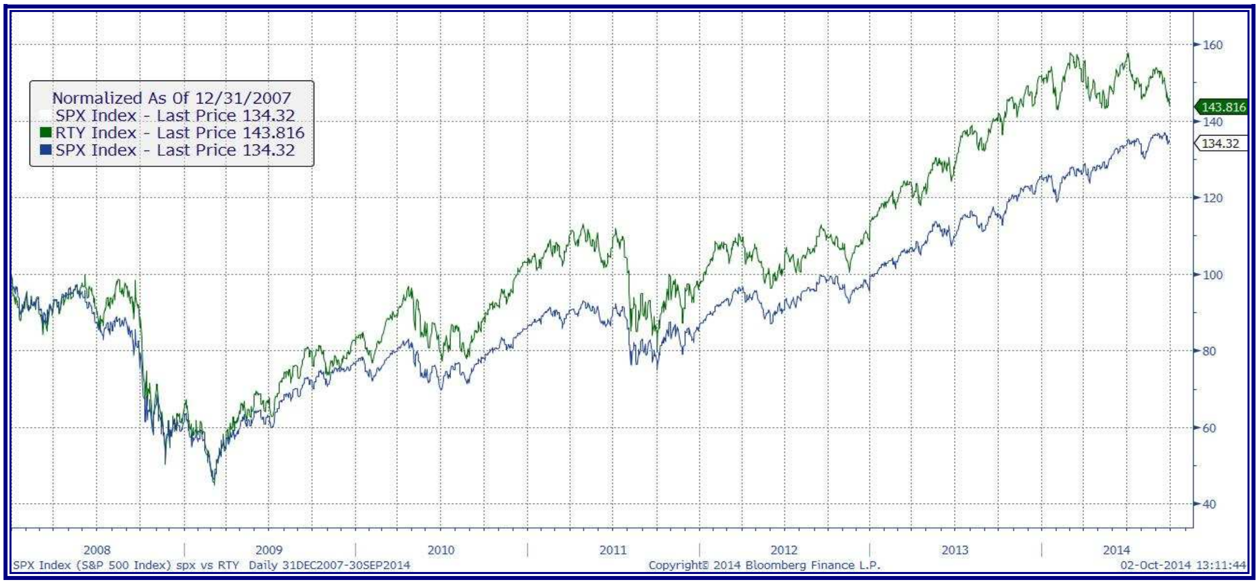
The Federal Reserve at its September meeting further reduced quantitative easing by another $10 billion per month, and its plan to exit the program by the end of October seems to be on target. The Federal Reserve is undoubtedly aware of the error made in 1937 when interest rates were raised prematurely, causing a recession at a time when the economy was recovering from the Great Depression. The reason for the increase was a fear of inflation. Given the monetary easing tendencies of Janet Yellen, Chairwoman of the Federal Reserve, and her constant restraint in wishing to lower unemployment further from the 6.1% current rate, it would appear that she is in no hurry to raise interest rates and change the zero interest rate policy. Her easing biases are no doubt reinforced by the currently low inflation rate of 2.0%, as measured by the CPI, as well as by the recent phenomenon of global economic weakening. Nonetheless, U.S. data is quite strong across many sectors and if it continues, particularly against a backdrop of rising inflation, then ultimately the Federal Reserve will have to begin a program of raising interest rates to normalize policy. Our view to date has been that the first interest rate increase will not occur until the second half of 2015.

Our forecast for 2014 remains at 2.75% real GDP growth, with CPI inflation slightly lower at 2.3% and a gain in corporate profits of 9.0%. For 2015, we expect real GDP to advance by 3.0%+, CPI inflation to modestly rise to 2.5%. We are currently assuming that the global slowdown will reverse to higher growth in 2015.

The Outlook for the Financial Markets

In secular bull markets, it is not uncommon for large cap stocks to out-perform small caps in the latter stages of a bull market. In 5 of the past 7 years, small cap stocks have out-performed as they often do following a recession. The tide appears to be shifting as investors at the outset in 2014 began once again favoring large cap stocks. We would expect this to continue in 2015.

EXHIBIT I
Standard and Poor's 500 Index versus the Russell 2000 Index

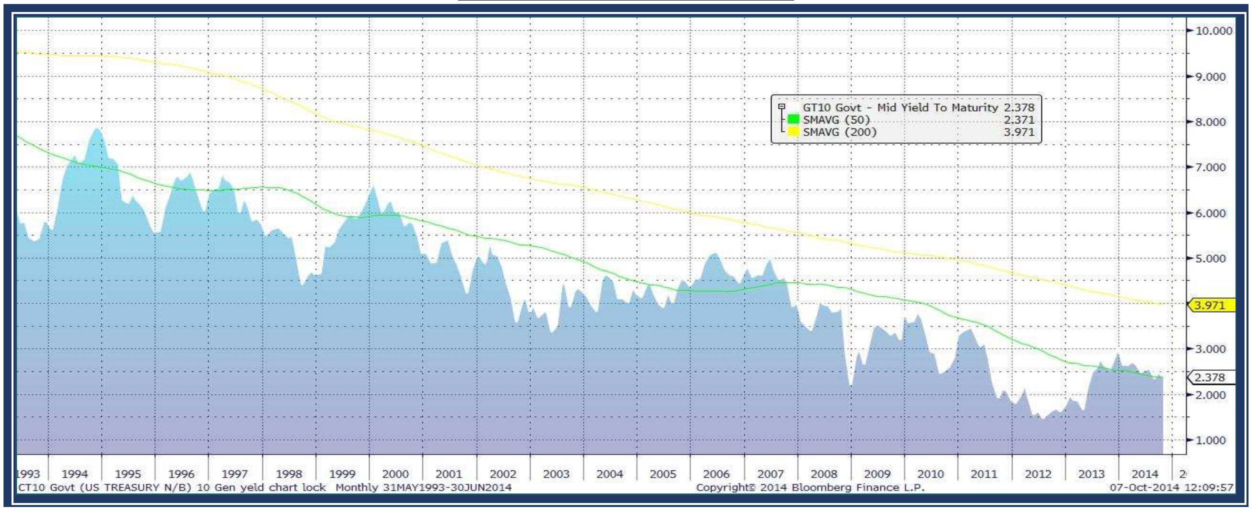


Source: Bloomberg and Altman Research

Over the past month, bond prices are higher, commodities are weaker against the backdrop of a strong U.S. dollar, and equity prices have moved down in sympathy. The declines appear to reflect the recent weakness in many global economies. As mentioned earlier, a number of countries are either in recession or close to it, particularly in Europe. The weakness in the euro, in contrast to the strength in the dollar, reflects this economic disparity. At present, the euro is worth 1.27 U.S. dollars. Recent Chinese statistics have been weaker, including housing data and exports. China uses about 40% of the world's copper and its current price at $3.01 per lb. is down from $3.20 per lb. a month ago and down 7.3% from year-ago levels. Gold, after a 7.0% rally in the first six months of 2014, has recently been quite weak at $1244 per ounce. We believe that this is a reflection of the low rate of inflation, despite global quantitative easing, and a manifestation of the general weakness in overall commodity prices. The CRB index (461) of all commodity prices has fallen 5.0% since mid-September with the worst performer oil currently trading at $81.95 per barrel down 13% over the same time period. U.S. production is now at a 45-year high because of the fracking revolution and inventories are substantial in relation to demand. If global growth was strong, as generally forecasted a year ago, commodities would be rising, not falling.

Bond prices fell modestly in September, perhaps anticipating the reduced quantitative easing and the possibility of higher interest rates ahead after the Federal Reserve meeting. However, that trend was materially reversed this past month and a more dovish response has begun to take hold. While quantitative easing was reduced, the interest rate outlook was not clarified from the Federal Reserve's earlier position. At present, the 10-year Treasury bond yields 2.20% versus 2.40% a month ago. Higher interest rates still appear likely in the future but the case for higher rates will not manifest themselves until global growth reasserts itself.

EXHIBIT II
10 Year Government Bond Yields



Source: Bloomberg and Altman Research

Equity prices marched higher through the third quarter of 2014, close in line with earnings gains. Price-to-earnings ratios have risen since the beginning of 2013 but not excessively so in terms of the major averages, such as the S&P 500 index. One should point out, however, that the "easy" monetary policy of the Federal Reserve has enabled Corporate America to engage in massive mergers and acquisitions, as well as record buyback programs, thereby creating excessive valuations in many segments of the stock market. The recent record IPO of the Chinese internet company Alibaba, valued at $232 billion after its opening gain of 38%, suggests that euphoria (often seen at new highs in the stock market) is again present. The famous book "Extraordinary Popular Delusions and the Madness of Crowds", written in 1841 by Scottish author Charles Mackay, should be read by all investors. It offers a balanced picture of the more popular speculations which periodically occur in human history.

At current prices, the S&P 500 Stock index (1886) sells at 16.1 and 15.2 times our earnings estimates of $117 per share and $124 per share for 2014 and 2015, respectively. These earnings estimates represent gains of 9% and 7% respectively over the two-year period. While the current P/E ratios are in line with the historic average over the recent past, they are not excessive, particularly if U.S. growth continues at a 3% or better rate with continued low inflation.

LOOKING AHEAD:

As we look forward, bond interest rates appear to be finding a bottom and we would expect rates to remain range bound into the first half of 2015. Stock prices - while always subject to corrections - should continue to move higher in step with rising earnings. Our expectation of earnings advancing 7% next year is based on a slight decline in profit margins, as wages climb modestly higher after years of little growth. We continue to believe that the main risks to stock prices emanate from geopolitical uncertainty coming from the Middle East. Earnings remain on a growth path extending the economic cycle, consumers are upbeat, and jobs are less hard to get, setting up 2015 for continued expansion and with potential for continued positive earnings surprises. All measures of profitability are on an uptrend and should provide a tailwind for the stock market.

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